TL-N-2804-91
CC:TL:Br3 Bowden/Coe
I.R.C. Sections 163(d) and 469

Internal Revenue Service
memorandum

CC:TL:Br3
GEBowden

date: FEB 8 1991

to: District Counsel, Seattle W:SEA

from: Chief, Branch 3, Tax Litigation Division CC:TL:Br3

subject: [redacted]

Your memorandum of January 7, 1991, requested Tax Litigation Advice with respect to the above referenced cases.

ISSUES

1. Whether the "substantial investment intent" standard applies to determine whether interest payments paid in [redacted] and [redacted] on loans to finance petitioners' purchases of interests in the [redacted], an electing S Corporation, are subject to the investment interest limitation of I.R.C. § 163(d).

2. Whether the tracing approach mandated by Treas. Reg. § 1.163-8T, and delineated in Notice 88-20, 1988-1 C.B. 487, for determining the application of the investment interest limitation is retroactive for passthrough entities to years prior to [redacted].

3. Whether the passive activity characterization rules of I.R.C. § 469 apply to allow the deduction of interest in [redacted], even though the activity had been disposed of in [redacted], via bankruptcy.

CONCLUSIONS

1. We conclude that the "substantial investment intent" standard may not apply to the interest at issue because of our resolution to issue 2.

2. We conclude that there is a substantial hazard that a court will find that the tracing approach of Notice 88-20 is applicable to the years at issue, notwithstanding a contrary intent on the part of the issuers of the notice.

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3. We conclude that by reason of I.R.C. § 469(m)(3)(B)(i) that the passive activity rules of section 469 do not apply to the interest at issue, because the taxpayers held no interest in the [redacted] on the enactment date of the Tax Reform Act of 1986.

FACTS

In [redacted], petitioner [redacted] purchased the [redacted], a [redacted] franchise affiliated with the [redacted]. The assets and liabilities of the franchise were transferred to [redacted], an electing S Corporation newly formed for this purpose. [redacted] was the sole shareholder of stock in [redacted]. [redacted]'s purchase of the franchise was largely financed by a loan. In [redacted], [redacted] apparently ran out of money to operate the [redacted] and sold half of the stock to petitioner [redacted]. In [redacted] and [redacted], both [redacted] and [redacted] borrowed money to operate the franchise. The corporation had employees, including a full time general manager. It appears that neither [redacted] nor [redacted] was ever an employee of the corporation. The franchise was terminated in [redacted] and the corporation was put into bankruptcy. By this time [redacted] and [redacted] had borrowed amounts in excess of $[redacted] to finance the franchise.

For their tax years [redacted], [redacted] and [redacted] [redacted] and [redacted] each reported the interest on these loans as investment interest. They were able to fully deduct the interest in these years because they treated income from two other S corporations ([redacted], and [redacted]) as investment income. On examination, the Service disallowed nearly the entire interest deduction, based on the revenue agent's conclusion that the income from the other S corporations was not investment income and could not be offset against investment interest. This resulted in an additional $[redacted] in tax and penalties being determined against the petitioners.

Petitioners now argue that the interest was not investment interest, but rather interest incurred in a trade or business. In the alternative, they contest the revenue agent's determination that the income from the other S corporations was not investment income.

DISCUSSION

Issues 1 & 2

The revenue agent's determination was based on a change in statute occasioned by the Subchapter S Revision Act of 1982. Prior to this enactment S corporation income was automatically investment income for purposes of the investment interest limitation. Section 163(d)(4)(C) was stricken by this Act, with the result that for years after December 31, 1982, the character of the income at the corporate level flowed through to the shareholders. Since the income of both S corporations was generated in the conduct of a trade or business, it could not be characterized as investment income.

As you discuss in your memorandum, this analysis is correct but may be largely inapplicable to [redacted] because of a transition rule provided for by the Deficit Reduction Act of 1984. This rule allows S corporations to elect to retain the pre 1982 characterization of income for tax years beginning in 1983 and 1984. The income reported from [redacted] in [redacted] derived from a year beginning in [redacted]. The election was properly made. This company accounted for most of the income characterized as investment income in [redacted]. Thus, the amount of investment interest disallowable will be reduced to that reported by [redacted] and [redacted] and offset by [redacted] income. We concur with your analysis of this point.

Other than in [redacted], however, there can be little dispute that the income generated by the other S corporation is not investment income. Accordingly, the analysis turns to whether the interest deducted is, in fact, investment interest. The traditional test, as enunciated in Miller v. Commissioner, 70 T.C. 448 (1978), is whether the purchase of the asset was devoid of "substantial investment intent." As you point out in your memorandum, G.C.M. 39529 concludes that interest incurred to by employees to purchase shares of stock in their employer, an S corporation was investment interest. If, as the G.C.M. concludes, S corporation stock should be treated like ordinary corporate stock, we believe that it is unlikely that petitioners could show that their purchases of the [redacted] were devoid of "substantial investment intent."

Subsequent Service pronouncements bring into question the continuing validity of G.C.M. 39529. In particular, Notice 88-20, 1988-1 C.B. 487, provides for a "look-through" or "conduit" approach to allocation of debt expenses for passthrough entities. In other words, if the debt can be allocated to assets purchased to be used in the trade or business of a S corporation, then the interest will be characterized as trade or business interest in the hands of the debtor shareholder. This notice further provides that it will be effective for years ending on or before December 31, 1987.

Petitioners contend that with this standard, all of the interest claimed in the years at issue would be trade or business interest. Your memorandum does not dispute this, but suggests that the notice may not be effective for [redacted]. You argue that the notice purports to be a modification of Treas. Reg. § 1.163-8T, which is effective for years beginning after December 31, 1986, and cannot be meant to take effect prior to the effective date of the regulation it modifies. You suggest that the purpose of the language is to allow a "look back" to prior years when a debt was incurred for purposes of allocations in years for which Treas. Reg. § 1.163-8T is effective.

Technical confirms that the intent behind the Notice was to have it apply only to the years for which the temporary regulation is effective. Frankly, however, we do not believe that the language of Notice 88-20 is ambiguous. It clearly states that it is effective for years ending on or before December 31, 1987. While your argument about the effective date of the regulation makes a certain amount of sense, there is no hint in the language of the notice that it is only meant to apply after the effective date of Treas. Reg. § 1.163-8T. Further, no absurd result is reached by interpreting the notice as taking effect prior to the regulation. In fact, there was a need for guidance to taxpayers on the treatment of interest paid in connection with the purchase of an S corporation. The approach adopted is consistent with that endorsed in legislative history and with Proposed Reg. § 1.57-2(b) (proposed in 1970 and since obsoleted). The subsequent Notice 89-35, 1989-1 C.B. 675, provides rules for interest allocations for years ending after December 31, 1987, and is quite clear that Notice 88-20 applies for earlier years. Accordingly, we believe that there is a substantial hazard that should this issue reach litigation, the court will find that Notice 88-20 has retroactive effect.

These notices specify that they are to be relied on by taxpayers to the same extent as a revenue ruling or a revenue procedure. On the other hand, general counsel memoranda, such as G.C.M. 39529, are not to be relied on by taxpayers and are not to be cited as precedent. Therefore, we will be bound by the clear language of our notices and unable to cite any contrary authority, other than the Miller line of cases, none of which deal with passthrough entities.

Further, we do not believe that this is necessarily the wrong result. Absent clear authority to the contrary, we think it is conceptually easier to argue that a "conduit" approach should apply both to determining whether S corporation income is investment income for purpose of section 163(d) and to determining whether the interest at issue is investment interest.

Issue 3

The final issue raised in your memorandum is only applicable to petitioners' [redacted] tax year. The passive activity loss rules of I.R.C. § 469 became effective for the 1987 tax year. If petitioners did not materially participate in the trade or business of [redacted], then their interest expenditures would be subject to the passive activity loss rules of section 469. If the interest expenditures are subject to section 469, they do not qualify as investment interest by virtue of section 163(d)(3)(B)(ii). However, section 469(m)(3)(B)(i) provides that pre-enactment interests are only subject to the passive activity rule if the taxpayer owned the interest on the date of the enactment of the Tax Reform Act of 1986. In the instant situation, because of the [redacted] bankruptcy, taxpayers did not have an interest in [redacted] as of October 22, 1986, the date of enactment of the Tax Reform Act. Accordingly, section 469 is not applicable to the interest expenses. Instead the tracing rules of Notice 88-20 will apply to determine the treatment of the interest under section 163.

SUMMARY

As discussed above, we conclude that the tracing rules of Notice 88-20 were only intended to apply to 1987. However, we believe that there is a significant hazard that the court will find the notice applicable to all the years at issue. This will have the effect of reducing the issue to a question of whether the debt proceeds can be traced to trade or business expenses of the [redacted]. Finally, we conclude that section 469 is inapplicable to petitioners' interest expenses in [redacted]. If we can be of further assistance in this matter, please contact George Bowden at FTS 566-3335.

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